FINANCIAL INSTITUTIONS COMMITTEE
Business Law Section, State Bar of California
Committee Website -- Click Here

Minutes of the Meeting of December 12, 2006

Committee Members Present: Rosie Oda, Chair; Bruce Belton, Secretary; Michael Abraham; Laura Dorman; Andrew Druch; Linda Iannone; Elaine Lindenmayer; Teryl Murabayashi; Todd Okun; Richard de la Pena; Keith Ungles; Joseph Sanchez; Will Stern; Robert Stumpf; Shirley Thompson; and Mike Zandpour.

Advisory Members and Others Present: Steve Balian; John Hancock; Robert Mulford; Meghan Mussleman; Michael Occhiolini; Maurine Padden; Steven Takizawa; Gerry Tsai; Chuck Washburn; and Clay Coon.

Committee Members Absent:
Meg Troughton, Vice Chair; Andy Erskine; Randy Kennon; Mary Price; Russ Schrader; Brad Seiling;

Call to Order: Our Chair Rosie Oda of Pillsbury Winthrop Shaw Pittman LLP called the meeting to order at 9:30 a.m.

1. Roll Call and Introductions: Rosie welcomed the Committee Members and the Advisory Members and asked each person to identify themselves and where they worked. Rosie introduced two new advisory members, Chuck Washburn of Manatt Phelps and Steve Balian of Styskal, Wiese & Melchione LLP.

2. Approval of November 14, 2006 Minutes: The Committee approved the minutes of the November 14, 2006 meeting.

3. Photographs and Bios: Kristin Gorts, a photographer from Pillsbury was available to take pictures for the Committee's website. Rosie reminded all Committee Members to submit their bios to appear on the website not later than December 19.

4. Vote on Proposed Administrative Changes and Other Administrative Matters:

a. One meeting in LA Per Year in LA. In furtherance of the proposal discussed in November to have one Committee meeting per year held in Los Angeles, it was voted upon and approved that the Committee meeting for April each year would be held in LA, location to be determined. The Los Angeles meeting for 2007 will be held on April 10th. Committee members were reminded to mark their calendars for that meeting date. Isabelle Ord will lead an ethics panel presentation and MCLE credit will be available.

b. Legislative Day in Sacramento – February 13, 2007 Meeting. Members were reminded that attendance is vital for the February meeting to be held in Sacramento at which time the Committee meets with Legislators. Last year's

meeting was not well attended. Everyone was encouraged to attend so that this important function can continue to be scheduled in future years.

c. Continuing Education Credit. MCLE credit will be available for attendance of Committee Member meetings. Roll will be taken at the beginning of the meeting for Committee attendance purposes and retaken at the end for phone-in callers who wish to earn MCLE credit (our Secretary, Bruce Belton, will add those members' names to the MCLE attendance list circulated in San Francisco). Bob Stumpf of Sheppard Mullin will maintain the attendance lists for the Committee.

d. January 2008 Section Meeting. Laura Dorman agreed to consider presenting a program for our Committee at the Section Education Institute in January 2008. Anyone interested in participating should contact her. The topic needs to be submitted in September.

e. Business Law Section News. Any members interested in submitting articles to the Business Law Section News should contact Rosie for information. The next deadline for submission is December 31, and thereafter January 26, 2007 for September/October program.

5. Recap of Annual Bar Meeting "Hot Topics" Presentation: Laura Dorman reported that a panel of five attorneys presented a discussion on Hot Topics in Financial Institutions Litigation at the Annual State Bar Meeting in October. In attendance were approximately 15-20 attorneys, consisting of litigators and business attorneys in private practice as well as in-house. The panel updated attendees on a number of legal developments in 2006, including the courts' treatment of federal preemption of state consumer laws; privacy and data security breaches; the National Bank Act in employment litigation; mandatory arbitration; and consumer class actions. Detailed course materials were provided attendees and published in brochure form. The panelists were Isabelle Ord, Sheppard, Mullin, Richter & Hampton; Joseph Catalano, Union Bank of California; Michael Abraham, Bartko, Zankel, Tarrant & Miller; Rosie Oda, Pillsbury Winthrop Shaw Pittman; and Laura Dorman, Citibank, N.A.

6. Miller vs. Bank of America: Will Stern of Morrison and Foerster LLP reported on the recent opinion in Miller vs. Bank of America from the California First District Court of Appeal. The Court distinguished between the process of account balancing versus setoff. Setoff is taking a debit from one customer account to credit another account of the same customer. (For example, paying an overdue balance on a credit card account by debiting funds from a checking account.) The trial court in Miller confused banker's setoff with account balancing which is the practice of applying credits to debits in the same account. For example, a deposit made later can be used to cover overdrafts or NSF fees charged to the same account. The practice of account balancing simply nets the credits against the debits in the same account. In *Kruger vs. Wells Fargo Bank* (1974) 11 Cal.3d 352, 521 P.2d 441, 113 Cal. Rptr. 449, the California Supreme Court held that public benefit deposits made to an account may not be used for purposes of banker's setoff. The Miller trial court extended *Kruger* to account balancing and found that the practice was a violation of Business and Professions code section 17200 and the Consumer Legal Remedies Act. The Court of Appeal reversed in a very clear ruling that the trial court had confused setoff with balancing. The rule that emerges is that while *Kruger* prohibits setoff of government protected benefits from a different account, it does not prohibit account balancing. The Court did not reach other issues. Plaintiffs filed a petition for rehearing in the case but the issues raised there should only be of concern to Bank of America, including whether Miller was an appropriate class representative. A petition for review by the Supreme Court is likely to be

filed but not likely to be accepted for review. Laura Dorman commented on a troubling footnote in the opinion that discussed item processing order. Referring to high-low payment processing, the footnote stated: “While this practice may be longstanding, it appears to work significant hardship on small depositors. However, its legality and propriety, although raised peripherally in this litigation, are not now before the court.” Will suggested that although there are pending cases on this issue, that ultimately the footnote should have a neutral impact. Will does not believe it will have an effect on the pending litigation in this area.

7. Abitrability of cases under the Elder Abuse and Dependent Adult Civil Protection Act: Maurine Padden of the California Banker’s Association reported about a proposed amendment to the California Elder Abuse and Dependent Adult Civil Protection Act (EADACPA) that has been suggested by the State Bar Trust committee. The proposal would apply the California Supreme Court's minimum requirements for the enforceability of mandatory arbitration clauses under *Armendariz v. Foundation Health Psychcare Services Inc.* (2000) 24 Cal. 4th 83, 6 P.3d 669, 99 Cal. Rptr.2d 745, to actions brought under EADACPA. *Armendariz* related to mandatory employment arbitration clauses. To the extent that arbitration agreements fail to contain the proposed five minimum requirements, this measure would void those arbitration agreements. According to the proposal, an enforceable agreement: (1) provides for neutral arbitrators that are selected by agreement of the parties; (2) permits discovery under Code of Civil Procedure Section 2016.010 et seq; (3) requires a written award; (4) neither limits nor prohibits the type of damages recoverable; and (5) does not require elders to pay either unreasonable costs or any arbitrators’ fees or expenses as a condition of access to the arbitration forum. Maurine suggested that the proposal was not entirely appropriate given its broad potential for application. It is unknown what impact this provision may have on the new California Elder and Dependant Adult Abuse reporting law effective January 2007. Laura Dorman commented that financial institutions lacked the right to place indefinite account holds under circumstances where potential elder abuse may be suspected, and whether or not the proposal could be amended to include such authority. Current law leaves financial institutions open to liability for wrongful dishonor under certain conditions. Maurine suggested that such protection could be considered apart from negotiating over the current proposed legislation, and perhaps by amendment to the Commercial Code. Will Stern asked whether the provision might also apply to NASD arbitrations, which are mandatory under that Association’s rules? Will suggested that the Committee should oppose the bill because arbitration is a useful remedy for both parties to a dispute. Bob Stumpf suggested that the proposal might be preempted by the Federal Arbitration Act. The Committee was asked whether it opposed the legislation based on its broad application, e.g., securities arbitration. Committee members were polled and it was unanimous agreed that the Committee opposes the legislation based on its broad application. Maurine reported that she would communicate the Committee’s position to the State Bar Business Law Section’s Executive Committee.

8. Watters vs. Wachovia Bank: Meghan Musselman of Hudson Cook, LLP reported on the US Supreme Court’s oral argument in *Watters vs. Wachovia Bank,* No. 05-1342*.* Argument was heard on November 29, 2006. The case involved Wachovia Bank’s attempt to operate a lending subsidiary in Michigan without registering under state law, and instead, insisting that the Bank was permitted to conduct its business as an operating subsidiary, further arguing that the National Bank Act preempts the application to State law to a national bank’s operating subsidiary. Both the trial court and 6th Circuit Court of Appeal ruled in favor of the Bank. Questions certified on appeal were: (1) whether the OCC had exceeded its authority in promulgating rules granting operating subsidiaries authority to preempt state law; and (2) whether the OCC had usurped state power under the 10th Amendment. The second issue was given very little discussion in the trial court and Court of Appeal, and although certified for

review the US Supreme Court, received very little attention in oral argument. Justices inquired about why a National Bank would use an operating subsidiary as opposed to placing the activity within a division of the Bank. The answer given was limitation of liability. Justice Roberts suggested that by permitting the limitation of liability while simultaneously allowing a preemption of state law, these Bank were “having their cake, and eating it too.” Justice Scalia referred to the statutory language in the National Bank Act stating that there was no authority for the OCC to regulate operating subsidiaries. Justice Souter found it “counterintuitive” that Banks would use operating subsidiaries but then subject those subsidiaries to state law. Another issue discussed was conflict preemption vs. field preemption and the Justices asking questions in this area seemed more concerned about whether Wachovia was asserting field preemption versus conflict preemption (this issue was not briefed by either party). The outcome is too close to call. Meghan’s Summary along with a hyperlink to the briefs is attached hereto.

9. Countrywide Bank NA Proposed Conversion to Federal Thrift: This item was tabled to the January meeting.

10. Financial Action Task Force Reports: This item was tabled to the January meeting.

11. Report: Legislative Subcommittee Update: Bob Mulford reported that the State Legislature is not in session.

12. Open Meeting, Other Items of Interest: None.

The meeting was adjourned at 10:40 am. Next meeting: January 9, 2007.

Agenda Item 8

U.S. Supreme Court Hears Oral Arguments in Case on OCC Preemption Regulations

This morning, the U.S. Supreme Court heard oral arguments in *Watters v. Wachovia Bank*, No. 05-1342. This case arises out of an attempt by Michigan to enforce its lending laws against an operating subsidiary of Wachovia Bank, a national bank. The operating subsidiary, incorporated under North Carolina law, had refused to register as a mortgage banker as required under Michigan law. In its brief, the operating subsidiary argued that it was not subject to Michigan lending laws because the National Bank Act preempts the application of state law to a national bank's operating subsidiary to the same extent as it preempts the application of those state laws to the parent national bank. In fact, the OCC has promulgated a regulation that states this conclusion with absolute certainty.

In its brief, Michigan argued that there is nothing in the National Bank Act that expressly preempts the application of state law to an operating subsidiary, nor is there any suggestion in the National Bank Act that Congress intended operating subsidiaries to wield the same preemptive power over state law as their parent national banks. It also argued that the OCC's attempt to infuse a creature of state law (the state incorporated operating subsidiary) with lending authority available only under federal law constituted an unlawful intrusion on state sovereignty under the 10th Amendment because it forced North Carolina (the state where the operating subsidiary was incorporated) to charter corporations who might wield powers the state might oppose and it prohibited Michigan from enforcing its laws against a corporation created under a sister-state law. Wachovia argued that the OCC was well within the authority granted to it by Congress under the National Bank Act when it issued regulations that located preemptive power in operating subsidiaries. It also argued that the Tenth Amendment issue, if any, is trumped by the fact that the OCC regulates banking, a matter affecting interstate commerce. Rules affecting interstate commerce are permitted under the Supremacy Clause of the Constitution, even of they impinge on state sovereignty under the 10th Amendment. Note that Justice Clarence Thomas recused himself from this case and was not present for oral argument.

During oral argument, Chief Justice Roberts wanted to identify the benefit that accrues to a national bank in placing certain operations or functions in an operating subsidiary and why a national bank would choose to use an operating subsidiary in lieu of creating a new division within the national bank. Both sides cited the fact that because a national bank is a separate entity from its operating subsidiaries, it is shielded from liability for the operating subsidiaries' activities. Through this line of questioning, Roberts appeared to make the point that national banks are receiving a benefit from the ability to place certain activities in an operating subsidiary and shield themselves from liability. Thus, in allowing an operating subsidiary to effectively act as though it is one with the national bank for purposes of preemption, the operating subsidiary is able to "have its cake and eat it too."

Justice Scalia, taking his typical strict statutory constructionist stance, focused on the fact that there is no statute granting the OCC visitorial powers over national bank operating subsidiaries. Scalia implied that the OCC had exceeded its authority in this vein, asking "what next?" If there is no statutory authority for the OCC to assert visitorial authority over national bank operating subsidiaries, what's to stop the OCC from expanding further the powers of national bank operating subsidiaries?

In contrast, Justice Souter expressed disagreement with Michigan's argument, finding it "counter-intuitive" that Congress would allow banks to use operating subsidiaries, but then subject them to state regulation.

The Justices expressed particular interest in whether Wachovia was asserting conflict preemption, where state law prevails unless a conflict with federal law arises, or field preemption, where federal law governs all aspects of a particular issue. The Justices, namely Roberts, Kennedy and Breyer, appeared to be more concerned if Wachovia were asserting blanket preemption for operating subsidiaries rather than conflict preemption.

Additionally, Justices Kennedy and Ginsburg focused on the fact that the operating subsidiary is subject to state law for corporate governance purposes, and that the state with such authority is North Carolina, the state of incorporation, rather than Michigan. This goes to Michigan's argument that a corporation is a creature of state law and that the federal government cannot federalize an entity under the state's purview. In asserting this point, Kennedy and Ginsburg appear to highlight the fact that states retain oversight of operating subsidiaries in the area of corporate governance and as such, there is no usurpation of state authority.

In sum, while Roberts and Scalia appeared to lean against finding OCC visitorial powers of operating subsidiaries, and Souter found such a conclusion "counter-intuitive," the Justices generally seemed to be searching for middle ground in focusing on the conflict vs. field preemption issue. Thus, it is very difficult to predict how the Court will rule in this matter.

Merits briefs are available at: http://www.abanet.org/publiced/preview/briefs/home.html